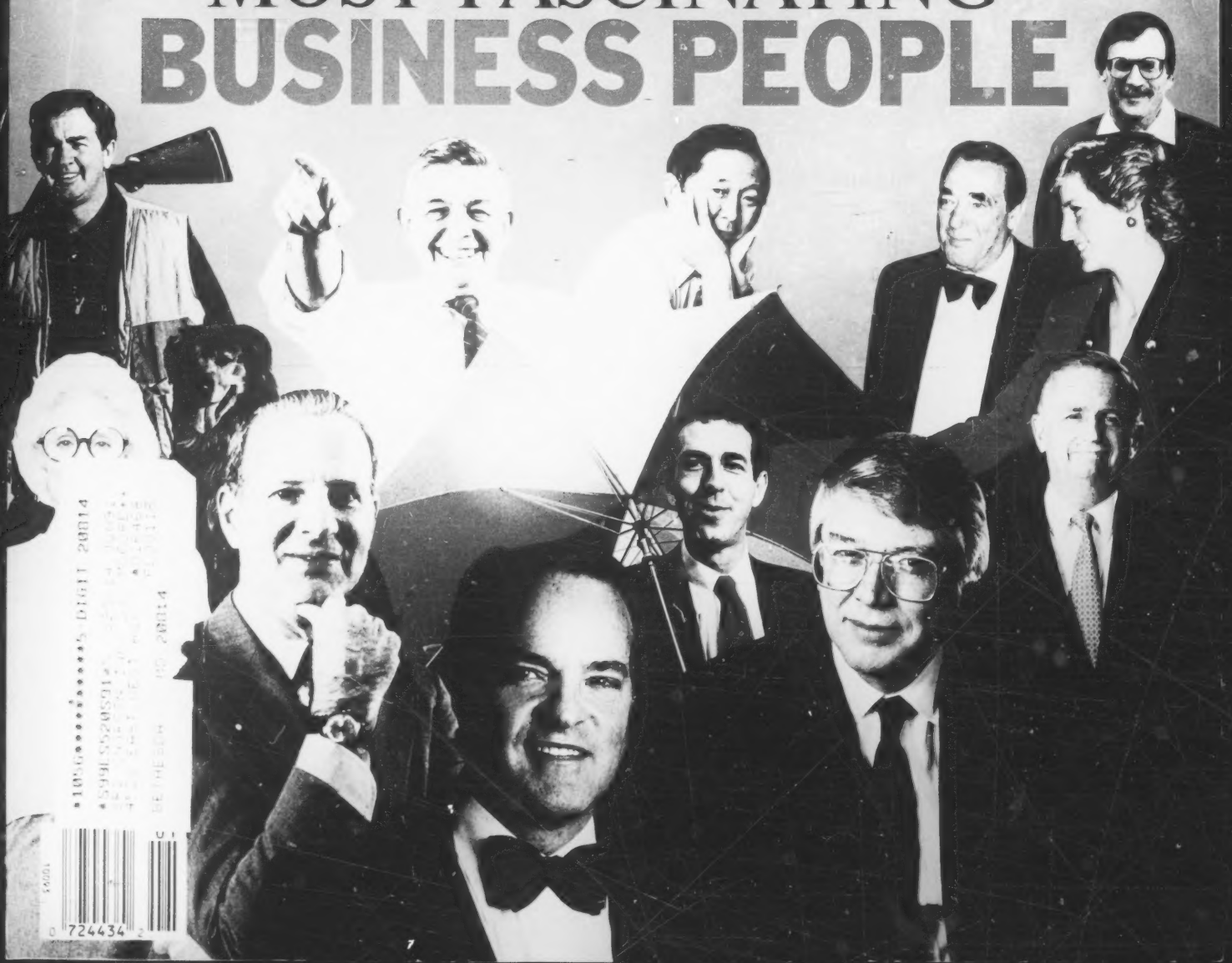
■ *EXCLUSIVE:* HENRY KRAVIS AND ROSS JOHNSON ON LBOs, RJR, AND GREED ■

JANUARY 2, 1989 $3.50

FORTUNE

THE YEAR'S 25 MOST FASCINATING BUSINESS PEOPLE



JANUARY 2, 1989

FORTUNE

SPECIAL REPORT/Cover Stories

THE 25 MOST FASCINATING BUSINESS PEOPLE OF 1988 — 32

Remarkable in all sorts of ways, the men—and one woman—on this list are above all bold, willing to take risks—to go ahead and pull the trigger on the deals of their lives. One is dead. At least one is a criminal. Many have transformed industries—even whole economies.

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"I brought a costume so that when he visits Steve Jobs in California, he can wear the right thing."

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"You can accurately be described as an international swindler on the highest level."

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"Once, only a few hours before we won, we wanted to call the whole thing off."

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"If we had any nefarious plan in mind, if we were greedy, we were pretty dumb about it."

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"This guy reeked of leadership."

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EDITOR'S DESK

LISA BOGDAN

Leinster, Brownstein, Newport, and Saporito fuel up for their task at breakfast.

NO RECENT business battle has attracted as much attention as the gladiatorial clash for ownership of RJR Nabisco between the two gentlemen pictured in the foreground on this issue's cover. Now that leveraged-buyout kingpin Henry Kravis of KKR has won the bout and $25 billion of spoils, what more can be said about LBOs? Turn to our Money & Markets section (page 66) and you will find that the answer is *plenty*.

JODI BUREN

Alan Farnham

Writer John Paul Newport Jr. leads off the section by answering the hard questions. Are LBOs good or bad for shareholders, employees, customers, and America's competitive strength? Will the huge pile of debt cascade into a wrenching series of bankruptcies when the next recession hits? Associate economist Vivian Brownstein wraps up the section with a forward-looking examination of where all the cash for financing the buyouts is coming from—and how long it will last.

Between these bookends you will find the most vivid and intimate accounts of the struggle for RJR Nabisco yet to be told. They come directly from the principals involved, in their own words. Winner Kravis told his story to Colin Leinster; loser Ross Johnson confided at length to Bill Saporito. Their tales capture the excitement, emotional ache, and physical pain of the fight—Kravis lost eight pounds and more than a few nights' sleep, Johnson lost his naiveté about Wall Street and finally his company.

Kravis and Johnson head our list of the year's 25 most fascinating business people. In the special report beginning on page 32, you will find a complete album of the rich, the righteous, and the roguish. Reporter Alan Farnham, author of six of the profiles, interviewed an imprisoned master swindler and a dapper FORTUNE 500 CEO in the same day. Any similarities? Notes Farnham: "They shared a love of free enterprise."

Credit the handsome look of the report to associate art director Renee Klein, who designed the layouts, and photo researcher Todd James, who collected pictures and cajoled subjects into posing. Observes Geoffrey Colvin, editor of the package: "These people are symbols of major change in business worldwide, but in our special report we insist on seeing them first as human beings—and that is fascinating."

Marshall Loeb

MANAGING EDITOR

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LBOs
GREED, GOOD BUSINESS -OR BOTH?

The outcry over these deals reflects way too much hysteria and far too little understanding. Herewith an interim report attempting to correct that imbalance. ■ *by John Paul Newport Jr.*

YES, there is some reason to be concerned about the pace and size of leveraged buyouts. The trend toward leverage, not only in LBOs but also in takeovers and on the balance sheets of ordinary companies, is big and growing. Says Charles Schultze, former chairman of the Council of Economic Advisers: "The numbers are beginning to be macroeconomically significant." And these highly leveraged companies have yet to be tested by recession. But there is no cause for panic. Much of the alarm triggered by the RJR Nabisco spectacle stems from an instinctive, unexamined fear of debt.

The RJR deal could be just one stop on an ever-increasing upward spiral, or it could be a high-water mark. Either way it invites an assessment of LBOs in general. For some companies they work almost like magic. But too many LBOs—at too high a price—could end up distorting the economy. The question is whether the efficiencies gained will be greater than the possible problems. Since the LBO era is far from being over, this has to be an interim report. On the following pages, Henry Kravis and Ross Johnson tell their own stories from opposite sides of the fight for the biggest buyout ever. A final article examines why so much money is available for these deals, and whether it will continue to be.

Many of the criticisms of LBOs suffer from a singular disregard for what might be called double-entry bookkeeping analysis. This holds that for every seemingly negative financial effect, one can usually find a countervailing positive effect, and vice versa. Nowhere is this clearer than in examining why the kind of breathtaking leverage that typically accompanies an LBO can be the best thing that ever happened to a company. This is not true for every company, certainly. But it is often true for companies with strong cash flow and mature businesses—like tobacco—that do not require large capital expenditures or extensive research and development to remain profitable.

Simply stated, by putting management under enormous pressure to meet outsize interest payments every quarter, a highly leveraged capital structure can improve a company's productivity dramatically. Michael Jensen, a professor at the Harvard business school, argues that without such pressure, managers often waste money. Says he: "You have corporations throwing off huge amounts of cash that they plunge back into slow-growth businesses with diminishing rates of return, or spend on ineffective mergers and acquisitions." If, however, the shareholders got some of this wherewithal, perhaps through an LBO, they could earn a higher return by investing somewhere else.

Typically, in an LBO managers have a greater equity stake in the new private company. This further motivates them to improve earnings. Though more managers of public companies have incentive pay packages these days, they are still compensated mainly with salary and the psychic rewards of running private empires. This mind-set hardly inspires them to sell off divisions or cut staff, even if doing so would boost the price of the company's shares.

Another advantage to the LBO structure is the deductibility of interest on the debt assumed. By this means, companies that have gone through an LBO can often eliminate taxes for several years. By contrast,

RISKS AND REWARDS OF LBOS

1. **Shareholders in leveraged deals score big.** Competing buyout groups are boosting premiums.
2. **Existing bondholders get the shaft.** Bond prices can plummet in the face of new debt.
3. **Profit margins rise after most LBOs.** Managers become owners and are more careful not to squander corporate resources.
4. **Recession could trigger LBO defaults.** But even bankrupt companies keep on producing.
5. **Deals reflect the tax code's debt bias.** If equity were treated more equitably, market forces should keep a cap on leverage.

REPORTER ASSOCIATES *Mark Alpert and Alan Deutschman*

dividends are taxed twice, both as corporate earnings and as income to shareholders. "LBOs are one of the most productive things to hit the economy in a long time," exults Jensen. A number of academic studies support his claim unambiguously. One found that the operating profit margins of LBO companies were 40% higher than their industries' medians two years after the buyout.

A CRITICISM frequently heard in the course of the RJR Nabisco saga was that LBOs enable management to steal a company from shareholders by paying too little when it takes the company private. But an increasingly competitive market for corporate control makes that all but impossible. If management puts the company in play, the likelihood is greater than ever that other bids will ensue. Directors have become steadily more aggressive about soliciting such bids. Ross Johnson's initial offer for RJR Nabisco was topped within four days.

Of course, if you are a double-entry thinker, you would expect LBOs to have negative side-effects, and you would not be disappointed. In the drive to cut expenses, employees are sometimes laid off. Still, people get fired even when ownership doesn't change hands, as companies restructure to become more productive. It is hard to argue that society at large loses out in the process.

In most buyouts the businesses sold off wind up in the hands of corporate parents that are better able to wring value out of them. A study by Steven Kaplan of the University of Chicago found that post-LBO employment at 33 buyout companies stayed about the same as before the deals. Those worrisome cuts in research and development? Companies that require lots of R&D—high-tech outfits, say—don't attract a lot of buyout bids.

Another frequent complaint is that LBOs hurt existing bondholders, and this seems to be true, particularly in some of the most recent deals. The sudden transformation of a corporation with little borrowing into a highly leveraged outfit makes payments on the existing debt less certain. The average price of RJR Nabisco's $5 billion of investment grade bonds fell 20% immediately after Johnson's buyout bid was announced. Significant but less dramatic declines in bond prices were recorded after buyout announcements at other companies, such as American Standard.

A number of angry bondholders sued RJR Nabisco for restitution after the announcement of management's buyout plan, including Metropolitan Life, which held $340 million of RJR bonds. But even after such unpleasantness, the bond market does not seem to be significantly discounting investment grade debt, even that issued by companies rumored to be buyout candidates. Issuers worried about the possibility can incorporate in their new offerings covenants and "poison puts" that require the company to make good on bonds suddenly devalued by buyouts or other changes in corporate structure.

FAR AND AWAY the biggest potential problem associated with LBOs is the limited flexibility with which management can maneuver in the event of recession, possibly leading to default and bankruptcy. These fears are serious, but often exaggerated. For one thing, when the debt in question provides high, equitylike returns, bondholders are more inclined to exhibit equitylike forbearance, and not press for default as readily as with traditional, lower-paying debt. Says Ronald M. Freeman, a managing director at Salomon Brothers: "People tend to see equity as a warm, fuzzy pillow and debt as a knife in the back. But if you're paying me an extra three percentage points for the high-yield debt, I'm willing to be understanding if you

HOW SOME PAST LBOs PLAYED OUT

COMPANY (Dealmaker)	PRICE (millions) Date	PREMIUM*	ASSETS SOLD (millions)		SALES† (millions)	PROFIT (LOSS)† (millions)	INTEREST† (millions)	EMPLOYEES
BORG-WARNER (Merrill Lynch)	$4,410 7/87	16%	$3,623	Pre-LBO	$3,379	$206	$53	82,600
				Most recent	$2,185	$448	$216	72,800
ALLIED STORES (Robert Campeau)	$3,583 12/86	36%	$2,200	Pre-LBO	$4,226	($53)	$153	61,800
				Most recent	$3,303	$3	$354	27,000
R.H. MACY (Management)	$3,518 7/86	55%	NONE	Pre-LBO	$4,653	$206	$98	55,000
				Most recent	$5,729	($188)	$570	70,000
BEATRICE (KKR)	$6,183 4/86	45%	$7,000	Pre-LBO	$11,396	$232	$300	100,000
				Most recent	$4,178	$931	$376	17,000
STORER COMM. (KKR)	$1,953 12/85	31%	$1,696	Pre-LBO	$592	($23)	$89	4,800
				Most recent	$480	$1	$221	2,925

*Difference between final offer to shareholders and stock price one month before first offer. †For last full year before LBO, and for most recent four quarters.

Leveraged buyouts are like snowflakes: Each is different. Since its buyout, Macy issued more debt and bought some new stores. It loses money. The other companies all shrank by selling off assets and then used the proceeds to reduce debt. Despite having to pay a lot more interest than before, these companies posted higher earnings, largely because they were able to achieve productivity gains.

get into trouble and I think you have a chance to pull through. We can negotiate new terms, maybe defer payments until the slump is over. I'm not doing it gratuitously, but because of the extra interest."

Even if some companies go bankrupt, the effect on the economy may not be as bad as is often supposed. Says Securities and Exchange Commissioner Joseph Grundfest: "Bankrupt LBOs are not firebombed. Their productive capacity does not disappear from the economy. They continue to do business, often with operating profits, as their capital structures are renegotiated." In the case of Revco, a drugstore chain and the largest LBO to go bankrupt so far, not one store was closed or one employee fired as a result.

To many critics, bank lending for LBOs represents the real time bomb. A recent Federal Reserve survey found that LBO loans accounted for 9.9% of all commercial loans at large banks. That's less than half big banks' exposure in Third World countries, but many top officials still find the amount troublesome. In October, Federal Reserve Chairman Alan Greenspan cautioned banks to watch their LBO lending more closely, and the Comptroller of the Currency is planning to examine bank LBO exposure in early 1989. That may prompt banks to think twice before getting into many more of these deals.

Spurred by disgust at the RJR Nabisco shootout, a lot of people in Washington are offering other solutions even before they have a firm grasp on the problems. An example: the proposal to eliminate the tax deductibility of interest on corporate debt. That presumably would discourage LBOs by making them more expensive. It would also get rid of what the critics see as a big loss of tax revenue. But it would make debt more expensive for young, growing companies that really need it. It would give acquisitive foreign investors an advantage since they would still have the deduction back home. Also, as FORTUNE reported (December 5), the tax losses from interest deductions may well be exceeded by revenues from capital gains and other taxes paid in connection with LBOs.

REPRESENTATIVE Edward Markey of Massachusetts, chairman of the House finance subcommittee, is talking about legislation that would distinguish between "productive debt" and "nonproductive debt." This seems a classic bad idea that would put the government in the role of deciding how much companies should borrow and why.

A more sensible approach would be to find a revenue-neutral way to eliminate the double taxation of dividends. Says Alan J. Auerbach, chairman of the economics department at the University of Pennsylvania: "There's a role for debt and a role for equity, but there's no reason that the tax system should discriminate against either one."

Apart from tax changes, control of the growth of debt is better left to the market. This is not without its perils. There is a huge pool of pension assets looking for a home and more than $20 billion in committed money waiting to do LBOs. Given the stock market doldrums, LBOs and leveraged takeovers are the only game in town. And LBO firms earn big fees for managing deals whether they pan out or not. Still, some market forces making for moderation are already at work. Competition is reducing rewards. New provisions on bond issues make buyouts more expensive. As the risks and rewards for leveraged buyouts become better known, lenders and investors may well exert more caution out of concern for their own position. In the end, the best antidote to excessive greed may be enlightened self-interest. F

PENSION FUND MANAGERS GET QUEASY

Meeker: no heartburn yet in Oregon

Although only about 5% of public employees' pension funds invest in LBOs, even such meager participation among traditionally cautious investors points up the sweep of the LBO revolution. Already, however, there is talk that the revolution may have gone too far, that all that money chasing too few deals is heightening the risk. Michigan's state treasurer, Robert Bowman, who invested some of his fund's money with Kohlberg Kravis Roberts, is particularly miffed at the RJR Nabisco buyout because he considers it a hostile takeover. He says he had an understanding with KKR that the firm would avoid such deals. "Obviously we can't get our money back from KKR," says Bowman, "but we're now one deal wiser."

Marshall Burkes, executive director of the Wisconsin Investment Board, says his trustees pulled back from new LBO deals as early as the end of last year. Michael R. Cook of Buck Pension Fund Services Inc., which advises the large New York State Teachers' Retirement System, warned clients last September that "the party is over."

Not everyone agrees. In Oregon they're not putting away the funny hats and noisemakers just yet. Like a majority of state pension funds, Oregon's operates under the "prudent-person rule," which requires that it act as any prudent businessman might in similar circumstances. Interpreting the rule broadly, the Oregon Public Employees' Retirement System in 1981 became the first state pension fund to invest in an LBO. It put $25 million into California-based Norris Industries and tripled its money in three years. Says state treasurer Tony Meeker about the anxiety over RJR Nabisco: "It's sort of like saying the day after the crash, 'We'd better get out of the stock market.'"

Meeker is prepared to keep Oregon's money where his mouth is. The state has put an unusually large portion of its $8.5 billion in pension money into LBO funds—7.5%, vs. the 2% to 5% that other funds typically invest. And it's all with KKR, though Meeker achieves some diversification by investing in several KKR funds. Says he: "If we were to start over, we would be looking for the best LBO funds, and that would lead us right back to KKR." Oregon's annual returns of 50% to 60% on the money may explain his enthusiasm. – **Rahul Jacob**

WHERE ALL THE MONEY COMES FROM

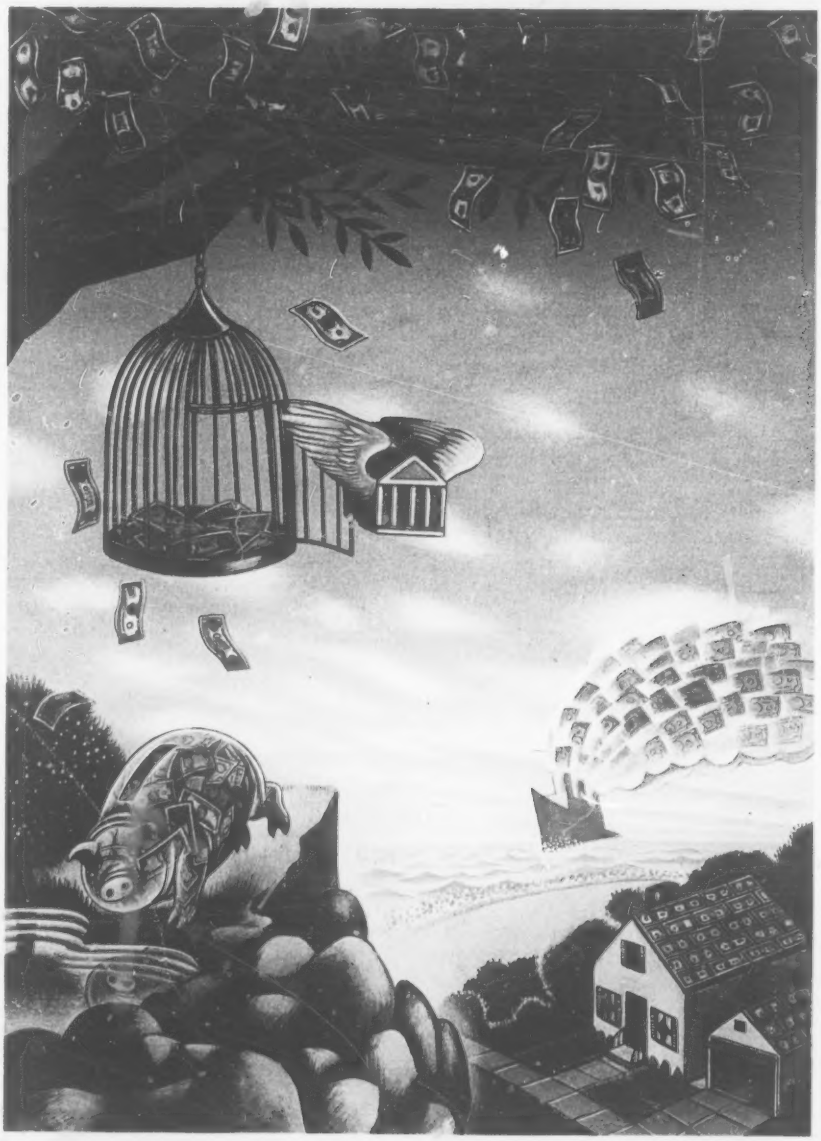
Cash for deals is flying in from everywhere—savings, pension funds, home equity, overseas lenders. The corporate borrowing binge does not seem too risky—yet. ■ *by Vivian Brownstein*

MERGERS. LBOs. Takeovers. Never have so many borrowed so much from so many. Where is it coming from, the famous "sea of liquidity"? Will corporations drown themselves in it—or, alternatively, might the money suddenly dry up?

Quick answers: It comes from everywhere, it introduces new but not necessarily lethal risks, and corporations are likely to keep on carrying more debt than they have in the past.

Ask any normally loquacious economist about the source of all this money and he is apt to splutter like a parent whose child asks, "Where do we come from?" His reply may be something akin to "We're from Detroit." The first problem is that liquidity means many different things. Take an exit poll at any neighborhood bank and most who reply are likely to say that their pocket cash and checkbook balance represent their liquid assets. More sophisticated folks might include money market funds and government securities, since these can be easily turned into cash. A FORTUNE 500 CEO would include his company's holdings of commercial paper as well. What these people are trying to figure is the amount of money they have to spend.

But look from a different angle. What we also see is a pool of *lendable* money. Thought of this way, potential liquidity is virtually unlimited. Says First Boston economist Albert Wojnilower: "In a world of floating interest rates, money is guaranteed to be available at the prevailing short-term interest rate." Liquidity, he notes, is really

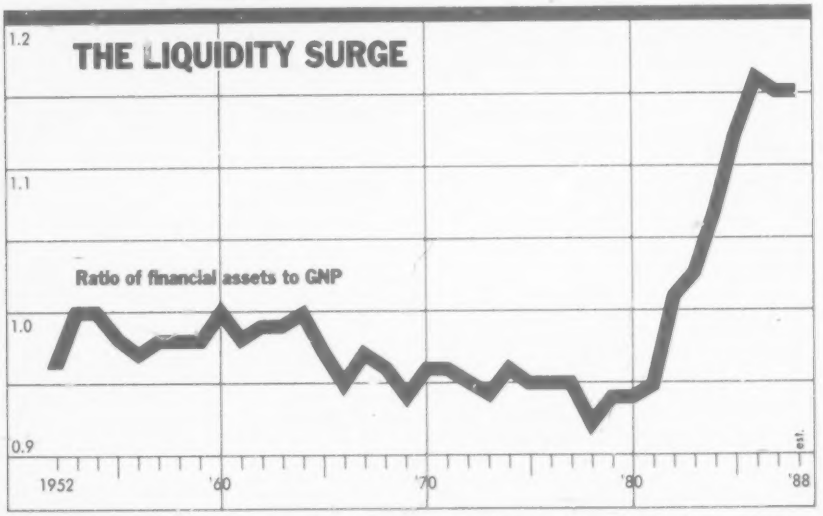


Unfettered interest rates have encouraged Americans to pour their money into the marketplace. Foreign investors are joining them, shipping back dollars by the boatload.

ILLUSTRATION BY JOO CHUNG

the willingness to lend combined with the willingness of central banks to maintain an interest rate that is not perceived as prohibitive. In a manner of speaking, all the money in the world is available if the price is right.

To put today's liquidity in context, look at the funds domestic investors put into credit markets in relation to GNP. As the chart below shows, lending has exploded. For every dollar of GNP, investors today are willing to hold nearly $1.15 worth of bonds, money market funds, CDs, and other financial assets—compared with be-



Americans are putting more money than ever into lendable assets, such as money market funds and bonds. Investors now ante up $1.15 of such funds for every dollar of GNP.

tween $.92 and $1.00 before. As a result, financial assets held by the public have increased more than $2 trillion in the past six years. By contrast, the cumulative decline in corporate funds from net new stock issues has amounted to less than $500 billion.

WHY HAVE Americans become so willing to lend so much? There are many answers. The 1980s stock surge certainly helped. The value of shares held by the public is almost double what it was in 1982, despite the decline in net new issues and the October 1987 crash. With their portfolios appreciating, investors freed up other money to lend.

Consumers are turning equity into debt too. Years of inflation pumped up the value of most homes. Until recently the gains were academic except for homeowners who planned to move. Now people are converting those gains into spendable or lendable funds by taking out home equity loans. Apparently they would rather do that than give up the income from their money market funds, which has helped push interest earnings to 14% of total personal income, vs. less than 10% during the 1970s. Tax reform has also provided an incentive because it is eliminating the deductibility of interest payments on other types of loans.

Thus, monetary deregulation has uncaged an important source of new liquidity—and one that is likely to last. Says economist Stephen Taylor, former head of the Federal Reserve Board's flow of funds section: "You don't have to be a sophisticated investor to get the market rate of interest these days, and savers will keep searching for the high interest they became used to seven or eight years ago."

Money is also pouring in from abroad. Investment capital is roaming the world, looking for the dynamic economy that is also safe. Foreigners still hold only a small percent of debt outstanding in the U.S. But in the first half of 1988 they supplied 21% of all the funds lent to domestic borrowers, compared with just 4% in the late 1970s (see charts, page 80).

That's counting only the money we know about. Official statistics do not catch all the money borrowed from abroad. Lending through U.S. offices of foreign banks is recorded in U.S. banking statistics. But, says economist John Wilson, who succeeded Taylor at the Federal Reserve, loans arranged directly with the head office of a foreign bank may not get captured in the accounts. Similarly, if a domestic bank sells part of a loan to an overseas bank, the loan can disappear from U.S. balance sheets.

Though the accounting methods aren't comparable enough to be precise, International Monetary Fund statistics suggest that foreigners could be lending *twice* as much in the U.S. as balance-of-payments data show. Foreign banks appear to be the major contributors to many LBO financing packages (suggesting that they do not foresee large dollar declines to come). Says one source close to several large Japanese banks: "They all want to lend more."

That could change, of course. Foreigners may not want to keep on putting their money into bigger and costlier leveraged-buyout deals. But they will continue to invest in U.S. business one way or another. The newly industrialized countries offer a higher return, but too many controls and problems for the old money of rich European investors. The Japanese have more dollars than other parts of the world can absorb. *Voilà*, the U.S. it is. And as long as the U.S. is running a large current account deficit, the Japanese and other foreigners will be adding to their pile of dollars.

PENSION FUNDS provide a major pipeline to the liquidity pool, and their contribution has grown in recent years. What's more, their role is even bigger than their share of the total would suggest. Pensions, money market funds, bond funds, and the like not only add to the total amount of liquidity but also concentrate it. Professional managers, presiding over more than half the money flowing from U.S. private investors, have much more influence on the financial climate than individual investors.

Altogether, U.S. nonbank financial institutions hold more than $6 trillion of assets. Public and private pension funds alone hold over $1.5 trillion. The money is usually invested conservatively, only 5% or so in high-risk, high-reward situations such as an LBO or venture capital fund. But that small share of institutions' money provides an important part of the financing available to firms putting together LBO deals. True, some pension fund managers are beginning to shy away from LBOs. But like consumers, they have got hooked on those handsome yields. If LBOs truly pale, they'll be looking for the

REPORTER ASSOCIATE *Rahul Jacob*

next high-risk, high-reward investment.

Banks, like pension funds, help mobilize money for mergers. They lend, they arrange consortiums of lenders, and they sell loans to other bank and nonbank lenders. No one knows for sure how big a role they play, including the Federal Reserve Board or the Comptroller of the Currency. But there are hints. A Fed survey earlier this year suggested that 15% of commercial and industrial loans were related to mergers, and at some large banks the figure rose to 40%. Those aren't such startling numbers, considering that banks have been pushed out of the markets for working capital loans, replaced by their former customers who lend to one another via commercial paper.

THE NEW BUSINESS is so rewarding that banks are not likely to abandon it as long as the money is in demand. When making loans for leveraged buyouts, they earn twice the normal spread over the London Interbank Offered Rate. So reports Christopher L. Snyder Jr., president of Loan Pricing Corp., a financial data firm. What's more, the up-front fees banks got from these deals over the past three months have on average been at least five times as much as they collect on standard working capital loans.

But given these temptingly high rewards, can bankers be trusted to make prudent loans? Worries about the great liquidity sea generally start with the risk to the banking system. The most pointed warning came when Federal Reserve Chairman Alan Greenspan cautioned banks to be sure their LBO loans are sound. Until recently banks have held only so-called senior debt—debt with the first claim on a company's assets if it goes belly up. Lately, though, some have started to take subordinated debt called "mezzanine" financing, which is more profitable but less secure. The large banks are not the only ones jumping into dangerous water. "The real risk is that the small institutions may have taken on too much debt relative to their size," says Goldman Sachs bank analyst Robert Albertson.

Still, it would probably take a deep and long recession to put the banking system in trouble. Recently the big banks have begun to shy away from selling LBO loans to smaller ones that haven't examined the risks carefully enough. "None of the lead banks want an LDC situation again," says Snyder, referring to the Third World loans that got many into trouble. Often overlooked, too, is that LBO loan customers are not a business category but a diverse portfolio. Some are cyclical, but others—particularly the most recent ones—are concentrated in sectors such as food where cash flows are more stable. "The only common factor is the high degree of leverage," says Wells Fargo CEO Carl E. Reichardt.

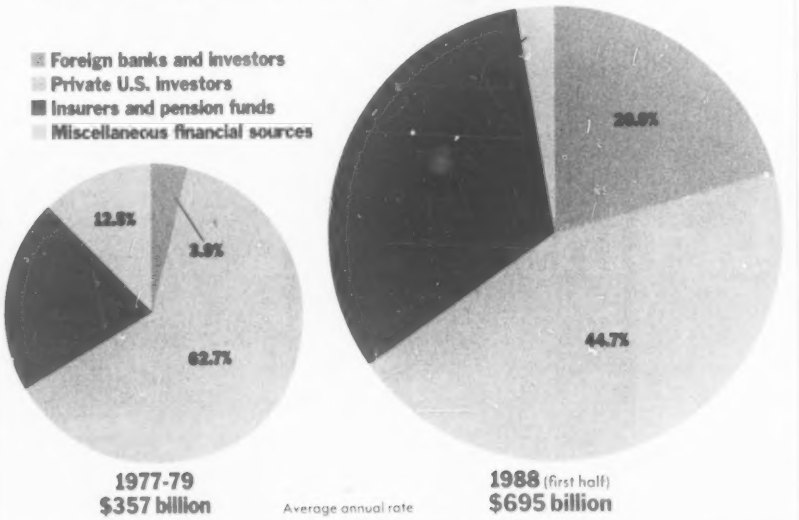
If the lenders aren't so vulnerable, what about the borrowers? The buyout of RJR Nabisco could put corporations over the top as the largest single group now tapping the U.S. credit market, bigger even than households. Nonfinancial corporations' share of total debt, which had hovered around 20% over the past decade, began shooting up earlier this year. Corporations absorbed 30% of all the lendable funds made available during the second quarter. Given the big LBOs pending, the figure for the last quarter could reach 40% of net new lending.

SO FAR, THE TOTAL corporate debt load does not seem menacing. Harvard economist Benjamin Friedman, for example, thinks that most of the debt taken on will not present any problems so long as earnings are continuing to grow. But watch out if the economy hits hard times, especially if the pace of leveraged buyouts continues for the next few years. Ben S. Bernanke and John Y. Campbell of Princeton studied 1,400 large corporations and concluded that up to 10% could go bankrupt in a very severe recession. Bernanke emphasizes the "very," but adds that even if they do not go bankrupt, the leveraged companies will make a recession worse. With large interest payments to meet, they are likely to be particularly aggressive in cutting other costs, such as payrolls.

The debt burden could also lead to higher inflation. Says Friedman: "The leveraging of the corporate sector has changed the risks that policymakers must consider when they decide whether or not to step in and try to stop inflation." At the moment, the Fed does not seem constrained—Greenspan has been letting the market push interest rates up. But Friedman questions whether the Fed would be willing to continue the good fight to the bitter end if it judged that many companies would be unable to stand a sharp drop in earnings.

Rather than provoking a financial debacle, the recent excessive phase of the buyout binge will probably just fade away. But with or without the specific device of the LBO, the restructuring of corporate America will continue. Companies will need capital, and investors searching for high returns will keep feeding the sea of liquidity. For good or bad, the world of decontrolled lending seems destined to produce more debt than before. F

WHO SUPPLIED ALL THAT CASH?



Pension funds, insurance companies, and foreign investors together supply more than half the money loaned in U.S. capital markets, nearly twice what they contributed a decade ago.

WAS BREAKING UP AT&T A GOOD IDEA?

The answer, on balance, is yes. Five years after divestiture, many customers enjoy lower costs and more choices, the industry thrives, and the technology has advanced. ■ *by Kenneth Labich*

YES Robert E. Allen, AT&T's chief executive, leads a leaner company that has gradually learned to compete but hasn't forgotten how to maintain standards.

CRITICS WERE nearly apoplectic when the Justice Department, citing antitrust laws, moved to break up the phone company. The laments echoed across America: Why mess with a telecommunications system that is the envy of the world?

As the fifth anniversary of the AT&T divestiture rolls around on January 1, that carping seems, in retrospect, ill-considered. Today the great majority of the country's telephone customers, large and small, declare themselves satisfied with the service they receive. Despite predictions that AT&T would pummel its fledgling competitors, the industry has evolved into an entrepreneurial, freewheeling marketplace where customers and many shareholders reap big rewards (see table).

Most important, the new competition has forced rapid technological change, in fact, a flowering of communications research. Says William McGowan, chairman of fast-growing MCI Communications: "Divestiture was essential. If we had not done this, the U.S. would now be at a competitive disadvantage with the world."

WHO WON AND WHO LOST?

The breakup's blessings have not been bestowed with absolute uniformity. The divestiture order allocated more expensive long-distance service—which had traditionally subsidized cheaper local service—to AT&T. At the same time the order put local customers in the hands of seven regional holding companies, the Baby Bells. This separation was expected to lower long-distance rates and raise local fees, and that is what has happened (see chart).

What about customers who seldom use long distance? They include many of the 90 million residential subscribers and the 18 million small businesses. These folks are paying, on average, nearly 35% more for their local phone service than five years ago.

But the rise has not been as steep as many had feared. The more pessimistic critics were predicting that local rates would double in a few years and that many poor and elderly would be forced to give up their phones because of the higher cost. The Federal Communications Commission reports that phone service has expanded since divestiture. About 93% of U.S. households have phones, up from 91% in 1983, and the percentage is even higher for the over-65 age group.

Judge Harold H. Greene of the U.S. district court in Washington, D.C., approved the consent decree between AT&T and the Justice Department, and as part of that agreement he has the job of administering it (see box). Though some critics, especially the Baby Bells, think he is too diligent in his

NO Wallace Aron, a consultant who had a recent telephone problem at his Portola Valley, California, home: "I'm more confused than I was. I never know who I'm dealing with."

REPORTER ASSOCIATE *Kate Ballen*

YES **By being able to negotiate with several different suppliers, says John DiChiara, director of information services at PepsiCo, "we've benefited up and down the line."**

task, only an act of Congress could turn it over to someone else. Responding to criticism about increased costs, Greene likes to recall in speeches that local phone rates had been going up at about a 6% annual rate before the breakup and that most of the big price rises are over. He also points out that residential subscribers and small businesses may well benefit from lower equipment costs. Before divestiture, most consumers leased phones, paying an annual rental fee of about $28 each. Now a cheapie model goes for less than half that, and even the top-of-the-line equipment costs little more than twice the old yearly rental charge.

For customers who use long distance a lot, of course, the picture is even rosier. Some corporations have sliced their communications costs more than 50%. Even with the big increases in local rates, overall phone service is only about 16% more than in 1983. Adjusted for inflation, the real cost for all phone service in the U.S. is a bit less than five years ago. Says Randall L. Tobias, vice chairman of AT&T: "If you stand back and look at the total picture, you are hard pressed to find anyone who has been substantially hurt by divestiture."

WHAT ABOUT SERVICE?

Here again the pessimists were wrong. True, some residential subscribers and small businesses who loved their rotary dials may believe the new telephone features are not worth the higher rates. They may also face the increased hassle of dealing with several companies when they pay their bills or have a service problem. When a line goes dead, these customers don't know whether to call the local company or the store that sold the phone. If the problem turns out to be that cute Bulgarian-made phone they picked up on sale, the one that quacks like a duck and doubles as a microwave oven, they could get hit with a service charge.

But the telephone system itself functions at least as well as in the past, and such technological advances as digital lines and fiber optics have improved service for many customers. Moreover, for many telephone users, divestiture has brought an extraordinary range of service options. AT&T used to offer barely half a dozen extra services, such as Touch-Tone phones and computer modem lines. Now the big long-distance carriers can provide over 100 options to customers—everything from exotic conference hookups to international data transmission. Major corporations are now able to tailor their communications networks to specific needs, knowing they can count on suppliers eager to compete for their business.

In a 1986 Gallup poll of diverse customers done for the U.S. Telephone Association, 84% of respondents rated post-divestiture service as either good or excellent. Another poll, conducted the same year by AT&T with the Consumer Federation of America and the American Association of Retired Persons, suggests that residential customers have adapted more quickly than expected to changes. More than 90% said they knew they had choices for long-distance service, 80% said they knew whom to call for problems with local service, 74% said they knew whom to call for equipment repair, and 68% said they found it easy to understand their bills.

Corporate and government customers are equally pleased. A study last year by a Massachusetts research group tracked subscribers, each with an average of nearly 1,000 communications lines. Over 80% rated their service good or excellent, while less than 3% responded with a "poor." Says William T. Esrey, president of long-distance carrier US Sprint: "For big business customers, the bottom line is that intense competition works. They are getting better service at significantly lower prices."

WHAT HATH COMPETITION WROUGHT?

At divestiture, critics were convinced that industry competition, intense or not, would be short-lived. They argued that AT&T, allowed to stay in lucrative long-distance and equipment manufacturing businesses, had plucked the plums and would easily dominate any competitors in those fields. Many Wall Street analysts were dubious about prospects for the seven regional holding companies. The Babies, it was widely speculated, would have trouble making a profit without Ma Bell's management and technological nurturing.

NO **"I'd push a button and go back to the old system if I could," says Bonnie T. Widenhouse, president of a small real estate firm in Charlotte, North Carolina.**

Record another "incorrect" for the doomsayers. The equipment business is populated by a gaggle of vendors from around the globe, aggressive marketers such as West Germany's Siemens and Canada's Northern Telecom. Hundreds of competitors have found safe niches in the long-distance market, and two of them, MCI and US Sprint, have become multibillion-dollar enterprises with the financial and marketing muscle to match up with AT&T. The Baby Bells, meanwhile, have generally

topped Mom in crucial financial benchmarks such as total return. Ten shares of AT&T were worth about $615 at divestiture; the shareholder who hung on to those ten shares, plus the seven Baby Bell shares thrown in with them as part of the breakup, is now holding stock worth about $1,300.

In fact, compared with some younger, nimbler players, AT&T has at times seemed more than a little clumsy. Weighted down with employees and unaccustomed to the thrust and parry of the open marketplace, the company reported disappointing earnings in the first several post-divestiture years. AT&T demonstrated its marketing naiveté when it made a ballyhooed entry into the personal computer business. The company assigned its old-line sales force, used to dealing with captive customers, to handle unfamiliar high-tech products and grapple with entrenched competitors. The result: losses of around $3 billion.

A modest turnaround began in 1986, as late Chief Executive James E. Olson slashed costs. Olson's successor, Robert E. Allen, 53, has maintained the momentum and instilled a more combative spirit in the once somnolent giant. Since 1984, AT&T has cut over $1 billion through employee reductions and plant modernization. Allen has tightened the focus of his sales force by creating strategic business units for specific customer groups; for example, manufacturers. The company, in December, won 60% of a multibillion-dollar contract to replace the federal government's telecommunications network. Even the computer division, still a money loser, got a big lift recently when it won a contract with the U.S. Air Force worth over $1 billion.

AT&T will take a $6.7 billion write-down in the fourth quarter of 1988, mainly to replace aging equipment. Though the move will produce the first annual loss in the company's 103-year history, most industry experts applaud Allen's continuing restructuring efforts. Says John F. Malone, president of the Eastern Management Group, a consulting firm: "AT&T has had to step up to the plate on some very disagreeable issues, and it has become a lot more business-like and aggressive as a result."

What most concerns AT&T executives is hanging on to their share of the long-distance business, the company's lifeblood. "I hope everybody here comes to work scared to death," says vice chairman Tobias. The company still controls about 80% of the market, but its fears are justified. First, competitors are making steady inroads. Second, the regional companies are asking Judge Greene for permission to get into the business.

MCI, with about 10% of the long-distance market, has become the most formidable opponent. Its revenues have galloped at a 27% average pace since divestiture, vs. less than 1% for AT&T, and most Wall Street analysts are optimistic about its prospects. MCI chief Bill McGowan, 60, doubts that he can continue to post such phenomenal gains indefinitely. But he does like the earnings outlook as his company enters arenas previously dominated by AT&T, particularly international long distance. Says he: "There is no safe harbor left for AT&T. We can do everything they do."

US Sprint, a partnership between GTE and United Telecommunications, has also emerged as a strong long-distance contender. The company, soon to be controlled by United Telecom, has yet to report a profit, but its $3 billion fiber-optic network is in place, and its revenues for 1988 should be up an awesome 35%. Its long-distance share is about 7%.

MCI's McGowan has built a $5 billion giant since divestiture.

WHAT DO BABY BELLS WANT?

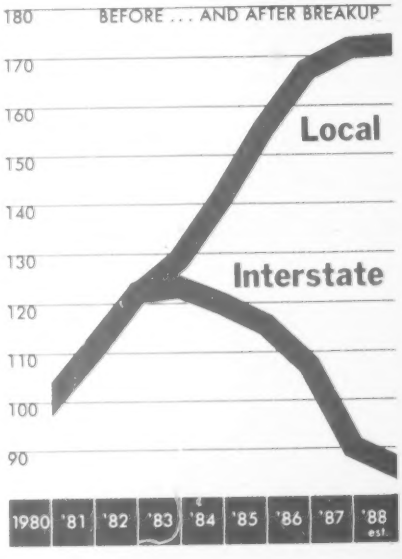
The seven regional companies continue to press for more freedom, particularly the right to be able to start their own information services, such as electronic yellow pages, in an effort to build on the considerable success they have had since divestiture.

Like little princes, the Bells started life with obvious advantages. They inherited an average of $17 billion in assets and effective monopolies for local service in their areas. But the Babies have prospered beyond expectations by cutting costs, reducing debt, maintaining top-notch service, increasing earnings, lobbying vigorously and often effectively for more operating latitude, and even venturing into such unregulated startup businesses as computer retailing. Says BellSouth Chief Executive John Clendenin: "All the sinister things, like fears about poor service and our finances going bad, have dropped by the wayside."

Each of the offspring has grown at its own speed. Some, such as BellSouth, were blessed with booming populations in their regions, while others, like U.S. West, have been stunted by the costs of maintaining service throughout big-sky country. California, where Pacific Telesis is located, has

THE UPS AND DOWNS OF TELEPHONE RATES

Index: 1980 = 100



been a bastion of pro-consumer commissioners who have been tough on rates.

All the Baby Bells are in the top ten on FORTUNE's annual list of largest utilities, and all have performed well for their shareholders. Says John Malone of the Eastern Management Group: "At divestiture investors were barraged with advice on which Baby Bell to buy. It turns out you couldn't have made a bad play."

HOW ABOUT NATIONAL SECURITY?

Before the breakup Pentagon officials argued that national security could be compromised in an emergency because they would not be able to use a single communications system to spread the alarm. Scientists grumbled that AT&T might cut funding or radically shift priorities at Bell Labs, long one of the world's premier research facilities. Experts differed with Judge Greene's assumption that more competition would spur advances in communications technology. In short, critics grossly overstated the harmful effects of divestiture on America's interests.

Defense Department concerns were handled at the outset. During the years of hearings before the breakup, the brass had argued that a more fragmented phone system could spell disaster in case of a natural catastrophe or armed attack. "We had the Bell System at our beck and call," recalls Lieutenant General William Hilsman, former manager of the National Communications System, the agency that oversees emergency preparedness. "It took us two years to figure out what we would do if we couldn't call AT&T."

The consent decree's answer was to order the Baby Bells to have a single point of contact. They set up an organization called Bellcore, which would function both as a research and engineering consortium and as a control center in the event of a national emergency. A National Security Emergency Preparedness group within Bellcore makes sure the regionals can respond to everything from hurricanes to thermonuclear war. Some dozen Bellcore managers concern themselves solely with security issues, and a contact person also resides at each of the regional companies. Bellcore has already proved its mettle in weather emergencies like hurricanes and tornadoes.

STEVE WOLF—PICTURE GROUP

Esrey has put fiber-optic cable (shown) throughout US Sprint.

Some federal employees still yearn for the good old days. Says National Communications System deputy manager Ben Morriss: "When companies are in competition with each other and trying to keep their costs down, they won't do certain things just for national security purposes. For example, each company installs less backup power for an emergency because it is more expensive."

But outsiders argue that divestiture has injected some fiscal reality into the process. Says Kenneth Flamm, a senior fellow at the Brookings Institution: "Now the Defense Department has to pay for what it wants, and that probably has the effect of making it get only what it really needs."

Hardly anyone predicted the breakup's one clear negative impact on the national interest. The U.S. has become a huge open market for the global peddlers of telecommunications equipment, especially business telephones and other hardware. At the same time, many overseas markets are largely closed to U.S. products because of trade barriers or local monopolies. A $275 million trade surplus in telecommunications gear in 1982 had turned into a $2.5 billion gap by last year.

continued

MA BELL, HER COMPETITORS, AND HER OFFSPRING

	REVENUES $ millions compound growth 1984-88	PROFITS $ millions compound growth 1984-88	TOTAL RETURN* 1984-12/5/88
LONG-DISTANCE CARRIERS			
American Telephone & Telegraph	$34,233 0.8%	−$1,700 N.A.	16.3%
MCI Communications	$5,146 27.3%	$315 52.0%	11.0%
US Sprint	$3,479 17.7%	−$173 N.A.	N.A.
REGIONAL COMPANIES			
American Information Technologies	$9,928 4.4%	$1,206 5.0%	25.4%
Bell Atlantic	$10,379 6.4%	$1,315 7.8%	24.7%
BellSouth	$12,976 7.7%	$1,667 7.3%	24.8%
Nynex	$12,713 7.5%	$1,296 7.1%	24.5%
Pacific Telesis Group	$9,486 4.9%	$1,207 9.9%	25.3%
Southwestern Bell	$8,463 4.2%	$1,065 4.8%	24.8%
U.S. West	$8,893 5.1%	$1,025 3.7%	24.0%

*Price appreciation and reinvested dividends. Estimates: Goldman Sachs

WHAT ABOUT R&D?

Most fears about Bell Labs have turned out to be illusory. Despite the fact that AT&T's revenues have shrunk to about 50% of predivestiture levels, the company has pumped up its R&D budget from about $2 billion annually at the breakup to about $2.7 billion in 1988. To make sure that the institution that gave the world such inventions as transistors and laser beams remains at the leading edge, AT&T continues to devote about 10% of the Labs' budget to basic research projects with no immediate commercial applications. Bell Labs, which has received over 25,000 patents since it was founded in 1925, still wins on average a new one each day.

Far more important for telephone users, competitive pressures are turning the concepts developed in the laboratory into products faster than before. About 30% faster, according to Ian Ross, president of Bell Labs. He says, "If you walk around the lab, there is a greater sense of urgency about implementing technology."

Divestiture has clearly accelerated the pace of some crucial new communications developments. One major example: fiber optics, which provide more capacity and clearer transmissions. AT&T had made long-range plans to put in digital lines, which include fiber optics. When MCI and US Sprint forged ahead with their own fiber networks, AT&T hustled to catch up, and by 1992 will have laid fiber throughout 94% of its system.

The Baby Bells are still prohibited from manufacturing their own hardware under Judge Greene's order, but they can develop computer software through Bellcore. They are also largely liberated from AT&T's technological monopoly; they can buy from anyone, anywhere. Says Michael Kennedy, a telecommunications consultant at Arthur D. Little: "You used to get a new service when AT&T was good and ready for it. The Bells had to queue up to get their new technology, like a bread line in Moscow."

THE JUDGE WHO RULES THE PHONE INDUSTRY

KATHERINE LAMBERT

"Divestiture has been very successful."

No man wields more power over *any* industry than Judge Harold H. Greene of the U.S. district court in Washington, D.C. He transformed the telecommunications business by approving the breakup of AT&T and now oversees the post-divestiture rules. Says William Baxter, chief prosecutor of the antitrust case: "Under another judge the entire industry might be very different today." Critics ask why a single person should hold such sway. Interviewed by FORTUNE's Kate Ballen, Judge Greene, 65, answers his detractors—and offers some personal insights:

Are you surprised that you are still so involved in the telephone system?

Yes. I thought once the decree was entered, there might be a little bit of controversy here and there, requests for this and that, but not on the constant basis there has been. Since the breakup I've probably received over 1,000 briefs because all the phone companies are constantly filing requests for enforcement and interpretation.

Is divestiture a success?

The main purpose of the decree was to bring competition into the telecommunications industry by way of reduced rates and more innovation, yet to keep the quality of the network at least as high as it was before. The divestiture has been very successful on all these fronts. In my opinion the most significant consequence has been the increase in innovations. It has been said that if GE had acted in the last 40 years as AT&T did, the American consumer would have the most durable light bulb in the world but no dryers and dishwashers.

Will you ever allow the regional companies into long distance, manufacturing, and information services?

The decree says that the restrictions should be lifted only when the regionals cannot use their monopolistic power to impede competition in markets they want to enter. That day has not yet arrived. Unless, of course, you assume the addition of a wolf to a flock of sheep would maximize competition in the flock.

The Justice Department, the regionals, and the Federal Communications Commission would like to give all control of the industry back to the FCC. How would you feel about this?

When outside forces come along and say we want to do what is the court's business, I obviously don't think that's a good idea. The decree was drafted by AT&T and Justice. I approved it, and the Supreme Court upheld my decision. This was a legitimate lawsuit. I've made it clear that any interested party can file on my decisions. Obviously the expectations of those people who want to transfer the power to the FCC or elsewhere figure that they would eliminate the restrictions or not enforce what I would.

Coming from Bell Labs: 3-D fax

Which company did you choose as your long-distance carrier?

I deliberately did not pick a long-distance carrier because I felt my choice could be used commercially in advertising. I waited for a carrier to be assigned—and it happened to be AT&T.

WHAT HAPPENS NEXT?

AT&T is pushing for a major change in the FCC rules that govern its long-distance business. Now the company is limited to a maximum rate of return of 12.2% on investment. To please shareholders it wants the freedom to boost earnings as much as possible. Its competitors, MCI and US Sprint, have no such earnings restrictions, but the Baby Bells do. Their limits are set by the FCC and the states in which they operate. However, half the states are considering or have already put in changes. Many states are contemplating a cap on phone call charges instead of earnings. The FCC may soon do the same.

Questioning the level of the playing field, AT&T also complains about regulations that bar it, and not its competitors, from negotiating prices with big corporate customers unless the FCC approves. Meanwhile, the Bells want permission to get into growth areas outside their present purview—such as manufacturing equipment, providing long distance, and generating information services such as electronic yellow pages and various data banks. Says Nynex Chief Executive Delbert Staley: "If you think you can restrict us to being phone companies, then you are condemning us to death."

But restraint may be the most prudent course for now. The price cap on call charges that AT&T is looking for seems a good idea; any business should have the right to earn its best possible return. But AT&T, with its huge market share, could still destroy its competitors by consistently undercutting their bids on big corporate accounts. The FCC should take another look at that situation when AT&T's competitors are a lot stronger. As for the Baby Bells, they could easily use their monopoly on local services to make a shambles of competition in such fields as long distance and information services. The Bells make a case for manufacturing: There is so much competition that it seems unfair to exclude them. But the FCC would have to make sure the manufacturing Bells do not use their dominance in an area to exclude other makers.

Yes, Judge Greene and the Justice Department have been right and their critics wrong. But there could yet be big trouble on the line if changes come too fast and extend too far. The regulators were correct when they plunged ahead with divestiture five years ago. Now they would be wise to heed the maxim they chose to ignore back then: If it ain't broke, don't fix it. F

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